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TAGS: ECON EFIN EINV ETRD LA
SUBJECT: FINANCIAL CRISIS BEGINS TO ERODE PILLARS OF LAO ECONOMIC GROWTH

¶1. (U) Summary: The weak integration of the Lao banking system with the international financial system initially cushioned the impact of the global financial crisis on Laos--there are no tranches of subprime debt in the Lao central bank. However, as the non-financial downturn has spread globally, Laos has begun to register its impacts, with the collapse of copper prices weighing heavily on exports and future government budgets, and with uncertainty about power demand, especially in Thailand, leading to the suspension of several major hydropower projects and questions about the pace of future expansion within the sector. The IMF has in recent months twice downgraded its expectations of future Lao growth and continues to emphasize the downside risk, and the World Bank now projects 2009 Lao economic growth at 5%. The Government of Laos (GOL), which only a month ago was predicting 8% growth in 2009, now appears to recognize the good times are coming to a halt. End Summary.

COMMODITY PRICE COLLAPSE CUTS BOTH WAYS

¶2. (U) As the global financial crisis began to freeze credit and push down the stockmarket in the United States, the GOL and many of the international financial institutions that support government spending downplayed its local relevance. The Lao Central Bank proudly noted that it had not purchased any subprime securities. Even as the crisis spread to Europe and Asia it was widely believed that Laos, with a banking system only weakly integrated into the global credit network, could escape a serious economic downturn. The fall of commodity prices, in particular copper, reminded the GOL that Lao economic integration has outpaced Lao financial integration into the global economy.

¶3. (U) As the price of oil has fallen, so has the Lao bill for imported petroleum products. According to the IMF, the positive balance of payments effect from lower oil prices should help offset the collapse in copper prices, previously the single highest value export from Laos. While the country as a whole might benefit from lower energy prices, the government is expected to see a loss in tax revenue equal to at least 1% of GDP from lower petroleum imports and mining exports. In recent years, the GOL has received substantial tax payments from Oz Minerals (previously Oxiana) and its Sepon gold and copper mine. Since 2003, Oz has paid the GOL over $230 million, with $135 million alone coming in FY 2007. Oz believes its taxes funded about 20% of the government budget in FY 2007. In September 2008, Oz General Manager in Laos Peter Albert publicly asserted that, if prices and profitability stayed high, Oz Minerals alone would contribute almost $2 billion to the government by 2020, dwarfing the expected $300 million contribution from the Nam Theun II

hydroelectric dam, often described as a project key to future Lao economic development.

¶4. (SBU) Peter Albert was recently laid off from Oz Minerals and the company may soon be forced to sell off large chunks of assets to stay alive. Richard Taylor, Oz Mineral's strategic analysis manager in Laos, told econoff December 19 that the company, which asked for a voluntary suspension of share trading in Australia through December 29 while it tries to refinance debt, had put itself up for sale as successful refinancing is unlikely. Mr. Taylor noted that the company is also temporarily putting off finishing a three-quarters complete $200 million expansion of its successful Sepon mine to conserve cash, although he expects the expansion to move forward in 2010. He believes the GOL is now coming to grips with the reality of the global recession and examining ways to minimize its impact on Laos. With copper prices falling almost daily, and currently around $1.30/lb, he sees Oz making 2009 tax and royalty payments of about $20 million - far below government expectations.

¶5. (U) Phu Bia Mining, another Australian copper and gold mining firm which began exporting copper concentrate in 2008, has also been forced to lower expectations of future tax payments. With copper at $3/lb, 2009 tax and royalty payments were expected to be approximately $85 million and 2010 payments $110 million. With copper prices falling, Phu Bia circulated a briefing noting that copper at $1.75/lb meant expected tax payments for 2009 production would fall to $12 million. As copper prices continue to fall, the company has announced it will delay its planned expansion and focus on maintaining profitability. The World Bank, in its

November Economic Monitor for Laos, projected mining tax and royalty payments of around $60 million in 2009 for Laos. However, this was predicated on $1.50/lb copper.

UNCERTAIN OUTLOOK FOR POWER SECTOR

¶6. (U) Rumors of major power projects running into financing difficulties have circulated recently in Vientiane. On December 17, the Director General (DG) of Investment Promotion in the Ministry of Planning and Investment, Houmpheng Souralay, said that developers of a planned 1,800 MW lignite plant in Hongsa, Xayaboury province, were halting the project due to the global recession. DG Houmpheng also announced that a number of large planned dam projects, including the 440 MW Nam Ngum 3, 523 MW Nam Theun 1, 278M W Nam Ngiep 1, and 1100 MW Nam Ou projects would be "suspended" due to financing difficulties and as a result of as yet unsuccessful attempts to revise the companies' power purchase agreements, primarily with the Electrical Generating Authority of Thailand (EGAT).

¶7. (SBU) In July 2008, the Ministry of Energy and Mines and the Lao State Holdings Enterprise (LSTE) began publicly discussing a need to renegotiate power purchase agreements (PPA) with EGAT to take into account the rise in materials costs, and the subsequent effect this would have on dam profitability, and price rises in alternative (natural gas and oil-fired) energy. EGAT reportedly agreed to renegotiate the PPAs, but has made little effort to do so. A former consultant to EGAT told econoff he believes there will be no new PPAs until the Thai government enjoys real stability and Thai electrical demand begins to rise. Dr. Somboun Manolom, General Manager of the LSHE, told the Embassy on December 17 that a wide range of planned projects would be delayed at least 1-2 years as EGAT is already projecting at least a 5% decline in Thai electricity demand in 2009. Dr. Somboun confirmed, however, that eight dams currently under construction will be finished, as they already have PPAs in place. Three of the eight, the 1088 MW Nam Theun II, the 615 MW Nam Ngum 2, and the 280 MW expansion of the existing

Theun-Hinboun dam, are designed primarily for export to Thailand. A fourth, Xekaman 3, is designed for export to Vietnam, while the remaining four (ranging from 2.4 to 120 MW) are for satisfying Lao internal demand.

TOURISM IN 2008 FLAT

¶8. (U) In December 2007, the New York Times ranked Laos as the #1 "Place to Go in 2008." The GOL took notice, projecting that over 1.8 million tourists would visit in 2008, up from about 1.6 million in 2006. Tourism accounted for about 8 percent of GDP and generated about $233 million in revenue during 2007. On December 8, the Lao National Tourism Administration (LNTA) announced that 2008 numbers were running only 3 percent ahead of last year through October, and that about ten percent of tourists had canceled visits since the start of the financial crisis. Additionally, package tour bookings in the first half of 2009 are running fifty percent below 2008, according to the Lao Association of Travel Agents. The closure of Bangkok's international airport in late November-early December briefly curtailed the number of visitors who could reach Laos from abroad and likely helped push total 2008 arrivals below that of 2007.

IMF RATCHETS DOWN GROWTH PROJECTIONS

¶9. (U) Benjamin Bingham, the IMF representative for Laos (based in Hanoi) told a November 24 gathering of donors and GOL luminaries at the UNDP-sponsored Round Table Implementation Meeting that the IMF was forecasting a 5.75% growth rate for Laos in 2009, down from about 7% in 2008. He emphasized the large degree of uncertainty about the projections and stressed that most risk was on the downside. Just a month earlier, at a World Bank gathering, Mr. Bingham and the senior World Bank economist for Laos, Katia Vostroknutova, had presented a much more optimistic picture of the Laos economy's reaction to the international crisis.

¶10. (U) In its November Economic Monitor, the World Bank projected 2009 growth in Laos at the "Low" end of about 5%, returning to about 6 percent over the period 2010-2013. This is not far from the average growth rate of 6.5% over the last two decades, and assumed the delays in most large power projects, zero growth in tourism in 2009, and an average annual two percent growth in agriculture, and four percent growth in services. In a December 19 meeting, the World Bank held to its projections, which include an uptick in 2010 to six percent GDP growth as the Nam Theun II project comes on line.

COMMENT

¶11. (SBU) After initially appearing to adopt a dismissive attitude towards the financial crisis, the GOL has begun to show greater concern and more dispatch. According to senior mining industry members, the Government met last week at the ministerial level to discuss appropriate policy responses. Robert Allen, General Manager for Country Affairs at Phu Bia, noted that the GOL suddenly agreed to a number of long-standing requests from the company, including an agreement to lower electricity prices. When the local English-language newspaper printed an article stating that Oz Minerals would be cutting over 50% of its staff (not true, says Oz), six separate ministers called the company to discuss its situation.

¶12. (SBU) The loss of mining revenue and slowing of foreign

investment will hurt the budget and slow GDP growth, but are unlikely to present any real challenge to GOL legitimacy. The mining sector, in particular, is quite new to Laos and essentially provided windfall revenue during the run up in commodities prices worldwide; most of that revenue was reflected in increased urban standards of living, with less influence on the rural majority. With the mining windfall ended for the time being, there will be more pressure from parts of the GOL bureaucracy to expand economic reform, as a means of attracting broader foreign investment. Rapid change is far from the norm here, however, and we expect reform to continue at a gradual pace. There will also almost certainly be more appeals to the donor community, including to rising donor China, to help Laos through this more challenging economic patch.

HAYMOND